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SUBJECT: MEXICO 2007 INVESTMENT CLIMATE STATEMENT -- PART II

REF: 06 SECSTATE 178303

This is part two of a two part cable that provides suggested text for the 2007 Mexico Investment Climate Statement.

Transparency of Regulatory System

The Federal Commission on Regulatory Improvement (COFEMER) under the management of the Secretariat of Economy is the agency responsible for reducing the regulatory burden on business. The Mexican government has made progress in the last few years. On a quarterly basis, these agencies must report to the Presidency on progress achieved toward Presidential goals for reducing the regulatory burden. In December 2006, President Calderon replaced the Regulatory Moratorium Agreement, issued by the previous administration to ensure agencies streamline their regulatory promulgation processes, with the Quality Regulatory Agreement. The new agreement intends to allow the creation of new regulations only when agencies prove that they are needed because of an emergency, because of the need to comply with international commitments, or because of obligations established by law.

The federal law on administrative procedures has been a significant investment policy accomplishment. The law requires all regulatory agencies to prepare an impact statement for new regulations, which must include detailed information on the problem being addressed, the proposed solutions, the alternatives considered, and the quantitative and qualitative costs and benefits and any changes in the amount of paperwork businesses would face if a proposed regulation is to be implemented. Despite these measures, many difficulties remain. Foreign firms continue to list bureaucracy, slow government decision-making, lack of transparency, a heavy tax burden, and a rigid labor code among the principal negative factors inhibiting investment in Mexico.

The Secretariat of Public Administration has made considerable strides in improving transparency in government, including government contracting and involvement of the private sector in enhancing transparency and fighting corruption. The Mexican government has established several Internet sites to increase transparency of government processes and establish guidelines for the conduct of government officials. "Normateca" provides information on government regulations; "Compranet" allows for on-line federal government procurement; "Tramitanet" permits electronic processing of transactions within the bureaucracy thereby reducing the chances for bribes; and "Declaranet" allows for on-line filing of income taxes for federal employees.

Efficient Capital Markets and Portfolio Investment

The Mexican banking sector has strengthened considerably since the 1994 peso crisis left it virtually insolvent. Since the crisis, Mexico has introduced reforms to buttress the banking system and to consolidate financial stability. These reforms include creating a more favorable economic and regulatory environment to foster banking sector growth by reforming bankruptcy and lending laws, moving pension fund administration to the private sector, and raising the maximum foreign bank participation allowance. The bankruptcy and lending reforms passed by Congress in 2000 and 2003 effectively made it easier for creditors to collect debts in cases of insolvency by creating Mexico's first effective legal framework for the granting of collateral. Pension reform allows employees to choose their own pension plan. Allowing banks or their holding companies to manage these funds provides additional capital to the banking sector, while the increased competition focuses fund managers on investment returns.

The financial profile of the banking sector has improved due to the reduction in the problem assets brought about by write-offs, problem loan sales, and the conclusion of most debt-relief programs. These developments, combined with more stringent capital requirements, have contributed to an improvement in the level and composition of capital across the banking system, particularly among the larger institutions.

Foreign bank participation, at over 80 percent of the banking system, is having a positive effect on Mexico's banking sector. The most apparent impact is the large size of equity

investments, which have been used to clean the acquired institutions' balance sheets. Additionally, higher foreign participation should improve the technology and risk management techniques (i.e. standards in auditing, accounting and disclosure) of the banking system. Examples of changes implemented by foreign bank owners include improvements in credit approval processes, loan documentation, and credit-related management information systems. With the support of strong international shareholders, these banks should also benefit from greater access to funding.

Bank lending, especially consumer lending and mortgages, grew rapidly in 2005 and 2006, fueled by lower interest rates and historically low inflation. Small and medium-sized businesses still complain of a lack of access to credit, but government-owned development banks have expanded their lending to this sector. Despite the expansion, such lending remains low as a percentage of GDP. Private banks argue that due diligence in lending to such business is difficult given the large amount of revenue kept off the books to avoid increased tax liability.

Commercial loans to established companies with well-documented accounts are available in Mexico, but many large companies have resorted to utilizing retained earnings to fund growth. Supplier credit is the main source of financing for many businesses. The largest companies are able to issue debt for their financing needs, tapping into a growing pool of pension funds looking for investment options. Non-bank financing is generally available, however, only to large companies with strong credit ratings and important commercial ties with their suppliers - i.e., companies that could easily procure bank financing. The Secretariat of Finance and Public Credit sets regulatory policy and oversees the National Securities and Banking Commission (CNBV), which is the primary banking regulator. Mexico's central bank, the Bank of Mexico (BOM), also has a regulatory role in addition to setting monetary policy. The Institute for the Protection of Bank Savings (IPAB) handles deposit insurance and is charged with finishing the work of the former insurance and

bank rescue fund, FOBAPROA, which took over large portfolios of bad loans from the 1995 banking crisis.

Recent reforms creating better regulation and supervision of financial intermediaries and fostering greater competition have helped strengthen the financial sector and capital markets. These reforms, coupled with sound macroeconomic fundamentals have created a positive environment for the financial sector and capital markets, which have responded accordingly.

The implementation of NAFTA opened the Mexican financial services market to U.S. and Canadian firms. Banking institutions from the U.S. and Canada have a strong market presence, holding approximately 40 percent of banking assets (as of June 2006). Under NAFTA's national treatment guarantee, U.S. securities firms and investment funds, acting through local subsidiaries, have the right to engage in the full range of activities permitted in Mexico. Foreign entities may freely invest in government securities. The Foreign Investment Law establishes, as a general rule, that foreign investors may hold 100 percent of the capital stock of any Mexican corporation or partnership, except in those few areas expressly subject to limitations under that law (Table I). Regarding restricted activities, foreign investors may also purchase non-voting shares through mutual funds, trusts, offshore funds, and American Depository Receipts. They also have the right to buy directly limited or non-voting shares as well as free subscription shares, or "B" shares, which carry voting rights. Foreigners may purchase an interest in "A" shares, which are normally reserved for Mexican citizens, through a neutral fund operated by a Mexican Development Bank. Finally, state and local governments, and other entities such as water district authorities, now issue peso-denominated bonds to finance infrastructure projects. These securities are rated by international credit rating agencies. This market is growing rapidly and represents an emerging opportunity for U.S. investors.

Political Violence

Potential investors should not find political violence a source of major concern. It generally takes the form of small localized conflicts and inter-communal disputes and has occurred mostly in limited regions of Mexico's southern

states. Since the initial January 1994 uprising of the Zapatista National Liberation Army (EZLN) in the state of Chiapas, government forces and the EZLN have clashed only once, although Chiapas has also experienced unrelated local violence. The Popular Revolutionary Army (EPR) and the Revolutionary Army of the People's Insurgency (ERPI) emerged in June 1996 and June 1998, respectively. They have carried out a number of small attacks, principally confined to the state of Guerrero. On November 6, 2006, three bombs exploded in Mexico City, one of which damaged a branch of Scotia Bank. The perpetrators and the motive of the bombings are still unknown although political factors are believed to be to blame; no injuries were reported, although property damage was reported at several of the targets.

The last half of 2006 saw intense protests in the state of Oaxaca demanding, principally, the state governor's resignation. The capital city of Oaxaca was under siege by demonstrators for more than five months. Businesses - particularly those in the tourist sector -- reported millions of dollars in losses and many Western countries, including the United States, issued travel warnings advising their citizens to avoid the area. At least 11 civilian deaths, including that of an American journalist, occurred as a direct result of the violence in Oaxaca and hundreds more were injured and/or arrested. State police forces were accused of denying due process to protestors and using excessive force to break-up the demonstrations. In response

to the escalating violence, President Fox, and later President Calderon, sent the Federal Protective Police to restore order. With the presence of federal troops, the city has been fairly calm with only sporadic public marches. The situation, however, remains delicate as the main demand of the protestors, the governor's resignation, remains unfulfilled.

Narcotics trafficking-related violence is prevalent along the northern border region of Mexico and has shown signs of spreading to other areas -- including the states of Guerrero and Michoacan -- as the federal government has attempted to crack down on the trade. The Government of Mexico, reported mixed results in reducing crime in the border region as a result of its "Operation Secure Mexico" program. During the first month of his tenure, President Felipe Calderon initiated "Operation Together Michoacan" and "Operation Tijuana" sending 7,000 troops to combat drug related gangs in the Michoacan state and additional troops to Baja California. He is planning on sending troop to additional states in the future.

The consulate in Tijuana has noticed that security concerns have increasingly been an issue for companies looking to invest in the Baja peninsula. The National Chamber of Electronics in Baja California has called for a State plan addressing security issues. Peaceful mass demonstrations are common in the larger metropolitan areas such as Mexico City, Guadalajara, and Monterrey.

Corruption

Corruption has been pervasive in almost all levels of Mexican government and society. President Calderon has stated that his government intends to continue the fight against corruption and government agencies at the federal, state and municipal levels are engaged in anti-corruption efforts. The Secretariat of Public Administration has the lead on

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coordinating government anti-corruption policy.

Other government entities, such as the Supreme Audit Office of the Federation (equivalent of the GAO), have been playing a role in promoting sound financial management and accountable and transparent government with limited success as most Mexican external audit institutions (mostly at the state level) lack the operational and budgetary independence to protect their actions from the political interests of the legislators they serve. Technical assistance is being provided to them by USAID to promote the use of modern auditing practices.

Mexico ratified the OECD convention on combating bribery in May 1999. The Mexican Congress passed legislation implementing the convention that same month. The legislation includes provisions making it a criminal offense to bribe foreign officials. A bribe to a foreign official cannot be deducted from Mexican taxes. Mexico is also a party to the OAS Convention against Corruption and is one of 13 countries

that have signed and ratified the United Nations Convention against Corruption.

The government has enacted strict laws attacking corruption and bribery, with average penalties of five to ten years in prison. A Federal Law for Transparency and Access to Public Government Information Act, the country's first freedom of information act, went into effect in June 2003 with the aim of increasing government accountability. With USAID assistance, 20 of Mexico's 31 states have replicated federal efforts by passing similar freedom of information legislation, the vast majority of which meets international standards in this field. Three years after its passage, transparency in public administration at the federal level

has noticeably improved, but access to information at the state and local level has been slow.

Mexico is ranked 70th in international NGO Transparency International's Corruption Perception Index for 2006, on par with China, India, and Brazil. Local civil society organizations focused on fighting corruption are still developing in Mexico. The USAID-funded Project Atlatl has worked to coordinate and promote anti-corruption activities with Mexican civil society (www.atlatl.com.mx) and other key players in the anticorruption arena, such as federal and state audit institutions. The Mexican branch of Transparency International also operates in Mexico. The best source of Mexican government information on anti-corruption initiatives is the Secretariat of Public Administration (www.sfp.gob.mx).

Bilateral Investment Agreements

NAFTA governs U.S. and Canadian investment in Mexico. In addition to NAFTA, most of Mexico's ten other free trade agreements (FTAs) cover investment protection, with a notable exception being the Mexico-European Union FTA. The network of Mexico's FTAs containing investment clauses encompasses the countries of Bolivia, Chile, Costa Rica, Colombia, El Salvador, Guatemala, Honduras, Japan, Nicaragua, and Venezuela.

Mexico has enacted formal bilateral investment protection agreements with 21 countries: 13 European Union Countries (Austria, Belgium, Luxemburg, Czech Republic, Denmark, Finland, France, Germany, Greece, Italy, Netherlands, Portugal, Spain, Sweden), as well as Australia, Argentina, Cuba, Iceland, Panama, South Korea, Switzerland, and Uruguay. Agreements with Australia, Iceland and Panama were signed in 2005, but the Senate still has to ratify them. Mexico continues to negotiate bilateral investment treaties with China and India.

The United States and Mexico have a bilateral tax treaty to avoid double taxation and prevent tax evasion. Important provisions of the treaty establish ceilings for Mexican withholding taxes on interest payments and U.S. withholding taxes on dividend payments.

Mexico and the United States also have a tax information exchange agreement to assist the two countries in enforcing their tax laws. The Financial Information Exchange Agreement (FIEA) was enacted in 1995, pursuant to the Mutual Legal Assistance Treaty. The agreements cover information that may affect the determination, assessment, and collection of taxes, and investigation and prosecution of tax crimes. The FIEA permits the exchange of information with respect to large value or suspicious currency transactions to combat illegal activities, particularly money laundering. Mexico is a member of the financial action task force (FATF) of the OECD and has made progress in strengthening its financial system through specific anti-money-laundering legislation enacted in 2000 and 2004.

OPIC and Other Investment Insurance Programs

In June 2003, Mexico and the U.S. Overseas Private Investment Corporation (OPIC) signed an agreement that will enable OPIC to offer all its programs and services in Mexico. The Mexican Senate approved full OPIC operations in August of ¶2004. Since then, OPIC has aggressively pursued potential investment projects in Mexico. OPIC increased its support for U.S. investment in Mexico more than tenfold when it approved 570 million USD in financing for new projects in February of 2005.

OPIC-supported funds are among the largest providers of

private equity capital to emerging markets. Since 1987, OPIC has committed (as of FY 2005) over 2.6 billion USD in funding

to 32 private equity funds. The OPIC funds currently investing in Mexico include Darby-BBVA Latin America Private Equity Fund, LP with a primary focus on equity investments in media and communications, transportation, consumer goods, housing, energy, and non-bank financial services and Latin Power III, L.P. focusing on equity investments in independent power projects ("IPPs") in Latin America and the Caribbean with a focus on renewable energy and Mexico.

Details of OPIC programs and recent investment project announcements can be found at their website: www.opic.gov.

Mexico is not a member of the World Bank's Multilateral Investment Guarantee Agency (MIGA), and has no plans to join. According to the World Bank, the Secretariat of the Economy provides the relevant services that MIGA would offer in Mexico.

Labor

Mexico's Federal Labor Law, enacted in 1931 and revised in 1970, is based on article 123 of the Mexican constitution. Under the law, Mexican workers enjoy the rights to associate, collectively bargain, and strike. The law sets a standard six-day workweek with one paid day off. For overtime, workers must be paid twice their normal rate and three times the hourly rate for overtime exceeding nine hours per week. Employees are entitled to most holidays, paid vacation (after one year of service), vacation bonuses, and an annual bonus equivalent to at least two weeks pay. Companies are also responsible for these additional costs. These costs usually add about 30 to 35 percent to the average employees' salary. Employers must also contribute a tax-deductible two percent of each employee's salary into an individual retirement account. Most employers are required to distribute ten percent of their pre-tax profits for profit sharing. The recently installed Labor Secretary has named labor reform as one of the top issues he will address during the next administration.

There is a large surplus of labor in the formal economy, largely composed of low-skilled or unskilled workers. On the other hand, there is a shortage of technically skilled workers and engineers. Labor-management relations are uneven, depending upon the unions holding contracts and the industry concerned. Mexican manufacturing operations are experiencing stiff wage competition from Central America, China, India, and elsewhere in low technology work, such as textile and garment manufacture.

For the past few years, strikes have been limited and usually settled quickly. Strikes that are more difficult will usually draw government mediators to help the settlement process. Independent unions have been playing an increasingly significant role, particularly since the formation of the new Labor Federation (National Union of Workers) in November 1997. Information on unions registered with federal labor authorities is supposed to be available to the public via Internet (www.stps.gob.mx), but this database is incomplete.

Foreign-Trade Zones/Free Ports

In addition to the IMMEX programs that operate as quasi-free trade zones, in 2002 Mexico approved the operation of more traditional free trade zones (FTZ). Unlike the previous "bonded" areas that only allowed for warehousing of product for short periods, the new FTZ regime allows for manufacturing, repair, distribution, and sale of merchandise. There is no export requirement for companies operating within the zone to avail themselves of tax benefits. Regulatory guidance for the new regime is still being amended; therefore investors should consult a tax lawyer for detailed information. Most major ports in Mexico have bonded areas ("recinto fiscalizados") or customs agents ("recintos fiscal") within them. There are currently two approved FTZ's, both operating in San Luis Potosi. The first major plant in the FTZ is currently under construction. Several states have

filed to convert their bonded areas into Free Trade Zones.

Foreign Direct Investment Statistics

Foreign Direct Investment in Mexico(USD Million)

	2002	2003	2004	2005	2006*
Total FDI Inflow:	19,344	15,348	22,283	18,934	14,112
-New Investments	11,385	6,012	13,328	9,463	5,106
-Earnings Reinvestment	2,440	2,067	2,330	3,460	3,048
-Inter-company Investment	3,476	5,308	4,150	3,190	3,688
-Maquiladora Investment in fixed assets	2,044	1,961	2,475	2,821	2,274

Foreign Direct Investment Realized in Mexico By Industry Sector Destination (USD Million)

	2002	2003	2004	2005	2006*
Inflow Total	19,344	15,348	22,283	18,934	10,864
Agriculture	93	11	16	3	2
Extractive	248	78	146	24	70
Manufacturing	8,647	6,685	12,694	11,363	7,092
Electricity and Water	398	323	202	192	(97)
Construction	348	83	385	277	125
Retail	1,778	1,394	1,183	2,648	208
Transport and Communication	832	1,631	1,254	1,173	368
Financial Services	5,765	3,306	5,489	944	956
Others	1,237	1,838	913	2,311	2,141

Foreign Direct Investment Inflows Realized By Country/Economy of Origin (USD Million)

	2002	2003	2004	2005	2006*	5 year
Total Inflow	19,344	15,348	22,283	18,934	10,864	86,773
United States	12,970	9,630	8,188	9,685	6,683	47,156
Spain	735	1,776	7,418	1,396	609	11,934
Holland	1,475	553	3,322	2,213	973	8,536
United Kingdom	1,249	1,056	138	967	613	4,023
Canada	221	255	499	256	319	1,550
Switzerland	462	312	1,100	169	340	2,383
Germany	596	463	399	347	67	1,872
Japan	166	122	363	88	56	795
Denmark	208	54	116	89	145	612
Singapore	59	(6)	30	12	22	117
South Korea	32	37	35	49	20	173
Taiwan	17	10	8	7	9	51
China	(2)	26	12	5	3	44
France	350	530	145	403	157	1,585

Notes FDI Investment Charts: 1) Sources: Inflow - Secretariat of Economy, Director General of Foreign Investment 2) Period: 2006 data January through September 3) Data: Millions of U.S. Dollars (USD), unless noted. 4) The Secretariat of Economy has recalculated values for past years. All values for past years are the most up to date data provided from the Secretariat of Economy. 5) The total FDI inflow for 2006 by

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sector and country is less than the total FDI in Mexico because it does not include an estimate that has been reported in the total FDI.

FDI INFLOW AS PERCENT GDP

	2002	2003	2004	2005	2006*
GDP	648,629	638,797	683,069	768,437	599,381
FDI Inflow	19,344	15,348	22,283	18,934	14,112
Percent GDP	3	2.4	3.3	2.5	2.4

Notes on "FDI as Percent GDP" chart: 1) GDP figures are taken from United Nations website. All Mexican sources give GDP in pesos only. Figures in millions of dollars 2) 2006 GDP is 3 quarter estimate using a 4 percent growth rate.

U.S. FDI Flow and Stock in Mexico (USD Millions)

	2002	2003	2004	2005
U.S. FDI flow in Mexico	7,656	3,664	6,361	6,771
U.S. FDI Stock in Mexico	56,303	56,851	63,502	71,423

Notes U.S. FDI Flow and stock in Mexico chart: 1) Source: U.S. Department of Commerce Bureau of Economic Analysis

Mexico FDI Flow and Stock in U.S. (USD Millions)

	2002	2003	2004	2005
Mexico FDI Flow in U.S.	2,349	2,173	(363)	349
Mexico FDI Stock in U.S.	7,829	9,022	8,167	8,653

Notes U.S. FDI Flow and stock in Mexico chart: 1) Source: U.S. Department of Commerce Bureau of Economic Analysis

In 2006 there were several large foreign investments in Mexico by U.S. and other nations' companies, including:

1) Isolux Corsan (Spanish) invested USD 355 million to construct a highway from Saltillo-Monterrey.

2) Daimler Chrysler invested 1 billion USD to modernize its plant in Toluca.
3) Ford invested 2 billion USD for equipment acquisition at its Hermosillo plant.
4) BBVA invested 110 million USD in Mexico for technological platform increases
5) Arcelor Mittal Steel invested 300 million USD in its Mexican operations.
6) Jatco (Japan) invested 200 million USD to increase production at its Aguascaliente plant
7) Mitsubishi Heavy Industries (Japan) announced a 600 million USD investment to construct an electricity generation plan in Guerrero state.

Web Resources
Secretariat of the Economy: http://www.economia.gob.mx

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Department of State, Office of Legal Advisor:
http://www.state.gov/s/l/
Mexican Development Bank: http://www.nafin.gob.mx
Mexican Foreign Trade Bank: http://www.bancomext.gob.mx
Mexican Civil Society: http://www.atlatl.com.mx
Overseas Private Investment Corporation: http://www.opic.gov
Secretariat of Labor and Social Security:

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